

Nos. 20375, 20382.

3369

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

W. THOMAS DAVIS and ELIZABETH LLOYD DAVIS, M.
PHILIP DAVIS and CAROLYN L. DAVIS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of the Decisions of the
Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

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Opinion Below.

The memorandum findings of fact and opinion of the Tax Court [R. pp. 28-57] was filed February 16, 1965 and is designated T. C. Memo 1965-30. It is unofficially reported at 24 T.C.M. 157.

Jurisdiction.

The petition for review [R. pp. 78-85] involves federal income taxes for the year 1953. Although it also referred to the year 1954, review of that year has been eliminated by stipulation. On June 9, 1961 the Commissioner of Internal Revenue mailed to the taxpayers notices of deficiency in the form of Exhibit "A" to

the petition in Tax Court Docket No. 94044 [R. pp. 10-19] asserting deficiencies as follows for 1953: against W. Thomas Davis and Elizabeth Lloyd Davis, \$76,534.98; against M. Philip Davis and Carolyn L. Davis, \$84,298.86. [R. p. 28.] Within 90 days thereafter, and on August 30, 1961, taxpayers filed petitions with the Tax Court for redetermination of those deficiencies under Section 6213 of the Internal Revenue Code of 1954; the errors, issues and facts were essentially the same in both petitions, one of which, that in Tax Court Docket No. 94044, is presented at R. pages 1-8. The decisions of the Tax Court were entered on May 20, 1965. [R. pp. 67-77.] These consolidated cases are brought to this Court by petition for review filed August 12, 1965. [R. pp. 78-85.] Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Question Presented.

In order to acquire the Del Norte orchard, the Davis brothers obtained options to buy the stock of the corporate owner. Of the total stock cost of \$889,615, \$500,000 was needed in cash; the Davises did not have it. However, they pre-arranged sales of corporate quick assets so that at a closing of escrows the \$500,000 was provided by corporate cash and cash from such sales concluded simultaneously with the stock purchase; the lemon crop on the trees, sold in this fashion, brought \$212,700 in cash to the deal.

After first allocation of \$440,778 of the stock cost to cash and quick assets converted to and used as cash, the cost of the fixed orchard assets was \$448,837. Relying on appraisal opinion rendered ten years later, the Tax Court decided that the fixed assets were worth more

than that when acquired. The Court reallocated cost on a percentage basis between the lemon crop and the fixed assets and concluded that a profit of \$76,572 was realized from the cashing of the lemon crop at point of purchase. Was this conclusion erroneous?

Statutes Involved.

Internal Revenue Code of 1939:

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

[Exceptions not pertinent]

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

[Adjustments not pertinent]

Statement.

1. Facts Found by the Tax Court.

Toward the end of 1952 Tom Davis began negotiations on behalf of himself and his brother Phil to acquire the assets of Del Norte Citrus Co., a corporation, herein called "Del Norte." These were conducted with the corporate stockholders, including its president, and resulted in the acquisition by Tophil Farms, Inc., a corporation wholly owned by the Davises, of options to buy all of the stock of Del Norte. The operating properties of Del Norte consisted of 428.35 acres of land in Ventura County, California, 354.26 acres of which were planted with lemon trees and improved with irrigation lines, tanks, wells, roads, various buildings and wind machines useful in operating a lemon orchard. [R. p. 30.]

After obtaining the options in May 1953, Tom Davis went to Europe, returning July 4, 1953. He thereupon gave his attention to raising the \$500,000 of cash needed to complete the purchase, which sum the Davises did not have available. He planned to use cash which Del Norte had in the bank and sell certain assets, principally packinghouse revolving fund certificates and the lemon crop set on the trees in various stages of maturity. The Davises intended to keep and operate the fixed assets constituting the lemon orchard. [R. pp. 30-31.]

Tom knew when he negotiated for the Del Norte stock that lemons were in short supply. Beginning July

4, 1953 he contacted representatives of a number of companies engaged in processing lemon juice concentrates, to inquire whether they were interested in buying the Del Norte crop. Six or seven individuals expressed an interest; a number of processing plants did not have sufficient lemons to meet their juice commitments and were anxious to buy the entire crop on the trees. Tom was asking \$2.50 per box for the lemons on the trees and had several offers of \$2.00 per box. He concentrated his negotiations with Eadington and Twombly, officers of Golden Citrus Juices, Inc. (herein called "Golden Citrus"), which was partly owned by Minute Maid Corporation, and had a contract with Minute Maid to supply its needs for lemon juice and products. [R. pp. 30-33.]

In late August or early September 1953 Tom verbally agreed with Eadington and Twombly to transfer the Del Norte lemon crop to Golden Citrus, as soon as the Davises acquired it, for \$2.00 a box of the estimated harvest from the crop then set on the trees from pea size to mature fruit. They accepted an estimate that 118,850 field boxes would be picked from this crop over the next nine months. Consequently they arrived at an oral understanding that Golden Citrus would buy the crop in its then condition on the trees for \$237,700 cash and would take all risks of loss or damage to the crop. The board of directors and principal stockholders of Golden Citrus approved these terms. [R. pp. 33-34.]

Accordingly, the written contract of September 12, 1953 between the Davises and Golden Citrus provided that as soon as the Davises acquired title to the Del Norte orchard they would sell the lemon crop to Golden Citrus for \$237,700 cash payable through escrow. Pursuant to this contract Golden Citrus placed the \$237,700 in a lemon crop escrow on September 17, 1953. At about the same time the Davises opened three other escrows. The four escrows were so arranged that the following was accomplished when they were closed on or about September 22, 1953: The Davises, who had received from Tophil Farms, Inc. an assignment of the options to buy the Del Norte stock, proceeded to exercise those options; Del Norte was dissolved and distributed to the Davises its assets, including cash just received by it from the sale of revolving fund certificates; a bill of sale from the Davises covering the lemon crop was delivered to Golden Citrus; the corporate cash and the \$237,700 of cash from the lemon crop escrow was used in paying for the Del Norte stock. [R. pp. 35-39.]

There was attached to the 1953 tax return of each of the Davises a statement reflecting and allocating the total cost of the Del Norte stock in a manner which may be summarized as follows:

Cost:

Cash paid stockholders	\$472,392.00
Notes to stockholders and others	394,835.67
Expenses of purchase and payables	22,387.60
Total cost	\$889,615.27

Allocated as follows:

Cash [largely derived from the sale of revolving fund certificates]	\$171,632.00
Accounts receivable	14,798.06
Inventory of lemons in warehouse	32,764.43
Oil inventory	6,031.26
Lemons on the trees	237,700.00
Deposit	900.00
Less adjustment for liability	(2,083.10)
Subtotal	\$461,742.65
Equipment promptly sold	4,035.30
Subtotal	465,777.95
Land, improvements, buildings, trees and equipment [fixed orchard assets]	423,837.32
Total allocated	\$889,615.27

The statement explained that the prompt disposition of certain of the foregoing assets for cash was considered to call for first allocation of cost to them and to other quick assets, such as cash and accounts receivable [the total of these being \$465,777.95]; and that the balance [of \$423,837.32] was allocated among the other assets largely in accordance with property tax assessments. [R. pp. 41-44.]

The notice of deficiency to each of the Davises increased his 1953 taxable income by \$101,429.50, stating that this figure:

“* * * represents a reduction in the cost of certain lemons sold from \$237,700.00 to \$34,841.00 or by \$202,850.00 of which your 50% distributable share is as shown by this adjustment. It is held that the fair market value of the growing lemons, including matured and immatured fruit, received in liquidation of Del Norte Citrus Company was overstated by the tenants in common.” [R. p. 44.]

The lemon crop sale contract contained a normal provision requiring the Davises as sellers to cultivate and care for the orchard while the crop was maturing, which provision had a value of \$25,000. [R. pp. 37, 38, 40.] The fair market value of the lemon crop when acquired by the Davises was \$212,700 [R. p. 41]; in other words, was the cash price of \$237,700 simultaneously paid by Golden Citrus, less the \$25,000 allocated to the provision for orchard care.¹

2. Price Allocation Procedure of Commissioner and Used in Judgment Below.

In the administrative stages of this case, including the deficiency notice, the Commissioner followed the

¹Provisions in the lemon crop sale contract whereby the Davises would share in profit made by Golden Citrus on the crop and, in return, guaranteed the pick, were inserted after the cash price had been agreed to; these added provisions offset each other, and in any event never came into play. [R. pp. 34-35, 39-40.]

taxpayers' method² of allocating the total cost of Del Norte assets in two steps: the first portion to quick assets at cash or face value; the balance among fixed orchard assets pro rata according to assessed values. This is evident from the following.

The statutory deficiency notice and the Revenue Agent's report proposed the same deficiency, to the penny. See, for example, the notice to Tom and Elizabeth Davis [R. pp. 11-14] and the Revenue Agent's report to them [Ex. 31, p. 1],³ each proposing a deficiency of \$76,534.98 for 1953. The Commissioner's method of readjusting the cost of the lemon crop and other assets appears on pages 4 and 17 of Exhibit 31. On page 4 he concluded that the crop had a value of \$34,841, which was \$2.35 a box for the 14,826 field boxes estimated to be ready for picking at date of sale; He reduced the crop value of \$237,700, which the taxpayers had claimed as crop cost, to this figure of \$34,841, thereby producing an adjustment of \$202,859. On page 17 he added this adjustment to a figure of \$433,903.88 thereby arriving at \$636,762.88 which he allocated percentagewise to fixed assets; the \$433,903.88 consists of the taxpayers' fixed asset figure of \$423,837.32 increased by two items included in taxpayers' list

²With a minor exception for oil inventory and a small amount of resold equipment, which will be explained.

³This Exhibit from the Tax Court record, along with Exhibits 28 and F, which were designated for reproduction but not reproduced in the transcript here, have been accepted by this Court for consideration in original form. Order of February 21, 1966, entered upon stipulation of the parties.

of quick assets, namely, fuel oil, \$6,031.26, and miscellaneous equipment resold promptly after acquisition, \$4,035.30. In other words, although the Commissioner treated the crop as worth only the resale value of the small portion ready for immediate harvest, he included it among the quick assets receiving first allocation of cost at full value. He did not include it among fixed assets to which the balance of cost was allocated among values on a percentage basis.

It was stipulated by the Commissioner at the trial that the amount by which the basis of the lemon crop was reduced below \$237,700 should be allocated among the fixed orchard assets according to the assessed value proration used by petitioners in their returns. [R. p. 45.] It will be apparent from the computation for entry of judgment that this was done and that oil inventory and resold equipment were again treated as quick assets, where taxpayers had included them originally. If any one of the figures allocated to fixed assets in the return [R. p. 43] is divided by the total cost of fixed assets (\$423,837.32), it will be found that the percentage is approximately the same as the percentage for that asset in the judgment computation. [R. pp. 65, 75.] It will also be noted by re-arranging the figures in the judgment computation [R. pp. 65, 75] and comparing them with the return allocation figures [R. pp. 42-43] that the judgment figures have been arrived at as follows:

First step: allocation of first portion of cost to quick assets at full face or cash value:

Cash [including cash derived from contemporaneous sale of revolving fund certificates]	\$171,632.00
Accounts receivable	14,798.06
Inventory of lemons in warehouse	32,764.43
Inventory of oil	6,031.26
Deposit on trees	900.00
Subtotal	226,125.75
Less Liability	(2,083.10)
Subtotal	224,042.65
Equipment resold	4,035.30
Total quick assets receiving first cost allocation	\$228,077.95

Second step: allocation of balance of cost among lemon crop and fixed assets:

Total cost	\$889,615.27
Less quick asset portion above	(228,077.95)
Balance	\$661,537.32

Allocated according to relative values found by Tax Court [see Op. below, R. p. 56]:⁴

	Value	% of Total Value	
Crop	\$ 212,700	20.58%	\$136,128.00
Fixed assets	823,300	79.42%	525,409.32
Total	\$1,036,000	100.00%	\$661,537.32

⁴The Tax Court arrived at its allocation by taking the cost of \$661,537.32 as a percentage (64%) of assumed value of \$1,036,000, and then applying that percentage to the individual

3. Comparison of Taxpayers' and Tax Court's Allocation and Valuation Figures.

For clarity in understanding the effect of the Tax Court's decision, we here reproduce in parallel columns summary figures derived from headings 1 and 2 of this Statement:

	Taxpayers' Figures	Difference	Tax Court's Figures
Total cost	\$889,615.27	—0—	\$889,615.27
First allocation to quick assets:			
Lemon crop (\$237,700)			
Adjust- ment for orchard care 25,000	(212,700.00)	\$212,700.00	—0—
Other quick assets	(228,077.95)	—0—	(228,077.95)
Subtotal	(440,777.95)	212,700.00	(228,077.95)
Remainder allocation to fixed assets	448,837.32	212,700.00	661,537.32*
Value of fixed assets (excluding lemon crop)	448,837.32	374,462.68	823,300.00

*Including lemon crop.

What the Tax Court has done in effect is to transfer part of the foregoing theoretical profit of \$374,462.68 to the lemon crop. The figures are as follows:

	Value	Allocated Cost	Theoretical Profit
Lemon crop	\$ 212,700	\$136,128.00	\$ 76,572.00
Fixed assets	823,300	526,409.32	297,890.68
Total	\$1,036,000	\$661,537.32	\$374,462.68

values, but the result is the same as that arrived at above. Because the 64% used by the Tax Court was a rounded figure, there is a small lack of correspondence between the percentages used above and the value figures to the left of them.

4. Tax Court's Valuation of Fixed Assets;
Appraisal Evidence.

It is the taxpayers' major position, concurred in by the Commissioner through the point of issuing his statutory notice, that the lemon crop was a cash equivalent entitled to first cost allocation along with the other quick assets. We believe that the Tax Court has committed manifest error of law in treating it otherwise. If this Court agrees, the Tax Court's valuation of the fixed assets is immaterial.

However, we believe that taxpayers' secondary point concerning valuation of fixed assets also deserves this Court's attention. From the comparative figures under heading 3 of this Statement, it will be apparent that the only basis which the Tax Court had for concluding that taxpayers made a profit upon immediate resale of the lemon crop, was its finding that the fixed assets had a point-of-purchase value in excess of their cost. Since the orchard has never been sold by taxpayers, this finding had to be based upon opinion testimony of the appraisal witnesses. [R. pp. 41, 55-56.] Therefore, we will now refer to the appraisal report and testimony of Hoffman, the Commissioner's witness, and the appraisal report of Taschner, petitioners' witness. [Exs. F and 28; 2R. pp. 236-296.]⁵

Between May 13 and May 19, 1964 Hoffman undertook to ascertain the fair market value of the fixed assets of the Del Norte orchard (land, improvements, buildings, trees and windbreaks) as of September 22,

⁵The reference "2R." is to the second volume of the Transcript on appeal. Exhibits F and 28 have been accepted by this Court for consideration in original form. See footnote (3) above. The appraisal report of Taschner was stipulated into the record below without testimony.

1953, a date 10½ years earlier. His method was to theorize from background information, such as the assessor's records; he conceded that his inspection of the property was cursory, saying that a current inspection would have little significance. He relied upon seven so-called "comparable" sales, of which five involved comparatively small parcels of 10, 30, 52, 63, and 69 acres, respectively, one condemnation sale of 109 acres was conceded to have little comparative value, and one sale (#7) of 86 acres occurred more than three years after the valuation date. [2R. pp. 246-286; Ex. F.]

He carefully specified that he took no account of the transaction involved here, by which taxpayers on the date of his valuation purchased the 428 acre lemon orchard he was appraising; and indicated that it would have made no difference to his valuation if he had known the price paid here. [2R. pp. 246, 284-286, 292-294.] He conceded that at the valuation date the subject property was still of only agricultural value, that subdivision and conversion to higher use was just starting in the general area, that small parcels were selling at a higher price per acre than large parcels, and that larger ranches may have stayed on the market a considerable time before being sold. [2R. pp. 253-256.]

Comparable #7 relied upon by Hoffman adjoined the Del Norte orchard and involved 86 acres of lemons, walnuts and some row crops with a good home on it. It sold on December 10, 1956 in active bidding, at a total price that averaged \$2,180 per acre including improve-

ments. [2R. pp. 266-267, Ex. F, Supporting Data, Sale #7.] Hoffman followed his comments about that comparable with his statement that he valued the 428 Del Norte acres at \$2,000 an acre, including improvements. [2R. p. 267.] He failed to explain why the 428-acre orchard was worth \$2,000 an acre in September 1953 when the much smaller 86-acre orchard was worth only \$2,180 an acre in December 1956, after three years of the trend toward subdivision and higher use to which he had referred.

Taschner, taxpayers' appraisal witness, set out upon a different course, namely, that of determining "the relative fair market values of the component parts of, plus certain chattels used upon" the Del Norte orchard as of September 21, 1953.⁶ and obviously did a careful job of inspecting the property itself as well as available records related in time to the valuation date. [Ex. 28, pp. 1-11.] His experience is impressive; since 1950 he has previously appraised over 2,000 farm properties including several hundred lemon groves. [Ex. 28, p. 13.] By comparison, Hoffman appears previously to have appraised one lemon grove. [2R. pp. 239-240.] Taschner's first three comparables are parcels of a size and price

⁶Taxpayers' counsel retained Taschner to make such an appraisal for the purpose of determining relative values of fixed orchard assets, as a basis for allocating among them the portion of the total cost remaining after first allocation to quick assets including the lemon crop. Concession of Commissioner's counsel, at opening of trial, that the percentage allocations to fixed assets used in the return could also be used in this case, made such an appraisal unnecessary. This concession was not foretold by pre-trial discussion between counsel and astonished taxpayers' counsel. See opening remarks of counsel. [2R. pp. 8-26.]

per acre that correspond with the size of the Del Norte orchard and the price per acre that taxpayers paid for it. [Ex. 28, pp. 14-16.] It should be noted that the \$448,837.32 paid by taxpayers for the 428 acres of the Del Norte orchard fixed assets (after allocating the first portion of total cost to quick assets) amounts to an average of \$1,049.00 per acre including improvements.⁷

Taschner's report concludes with the following significant statement [Ex. 28, pp. 11-12]:

"The total of relative fair market values and component parts arrived at above does not represent my opinion of the fair market value of the lemon orchard which is made up of those parts. A property of this size in the year 1953 was one that would not be readily marketable because the number of available buyers was limited in view of size. If a single unit will sell at a certain price, it will not necessarily follow that the multiple of those units would sell at the same multiple of that price; the greater the multiple the greater the discount.

"I am advised that the Del Norte Citrus Company Orchard on September 21, 1953 was owned by a corporation containing other assets, the stock of which was purchased by Messrs. Tom and Phil Davis on September 22, 1953. I am advised that after deducting from the price paid for the stock, the cash and cash value of assets immediately sold, the remaining portion of price allocable to the orchard components that I have appraised was less than 50% of my total appraisal value of the com-

⁷It is not clear where the Commissioner's counsel got his figure of \$409 an acre about which he questioned Hoffman [2R. 284-285] but he was apparently referring to some calculation he had made with respect to bare land.

ponents. A somewhat similar transaction occurred in 1952, as set forth in Comparable 1, in which the price attributable to a lemon orchard property of almost identical size to the one in question would appear to have been quite low.

"In my opinion, the fair market value of the orchard made up of the components that I have valued would be a fraction of the total of my values for the components. Such fair market value would depend upon what a willing buyer would pay to a willing seller for the entire 428 acres, comprising all of the aforesaid components as a result of negotiation in which neither party was acting under compulsion or duress.

"Even though the property was acquired by purchasing stock of a corporation and dissolving the corporation, it is reasonable to presume that the value of all of the assets of the corporation was known both to the buyers and sellers of the stock. If it were true, as I have been advised, that the assets of the corporation consisted essentially of the lemon orchard plus cash and assets promptly converted into cash, then in my opinion the best evidence of the fair market value of the orchard is the price paid for the stock, less the amount of such cash and cash to which assets were promptly converted."

The Tax Court's determination of fixed asset value of \$823,300 was evidently in reliance upon its subordinate conclusion that "There is no substantial disagreement between respondent's and petitioners' expert witnesses with respect to the valuation" of those assets, except for trees. [R. p. 55.] Apparently the Tax Court did not carefully read Taschner's report.

Specification of Errors Relied Upon.

1. The Tax Court erred in treating the lemon crop sold for cash at point of acquisition as a fixed asset entitled only to percentage allocation of remaining cost, instead of including it with the other quick assets entitled to first allocation of cost.
2. The Tax Court erred: in concluding, on the basis of an appraisal opinion given ten years after the event, that retained fixed assets were worth more at the point of purchase than the price paid for them; and in assigning part of the consequent theoretical profit to the cashing out of the lemon crop that occurred contemporaneously with the purchase.

Summary of Argument.

In the interest of brevity, the Court is respectfully referred to the headings under "Argument" in the Index as a summary of petitioners' argument.

ARGUMENT.

I.

In the Understanding of the Davises and in Economic Reality No Gain Was Realized Upon Sale of the Lemon Crop for Cash at Point of Acquisition; This Was Only a Transitory Step in Their Acquisition of the Fixed Orchard Assets.

The Davises wanted the Del Norte orchard. In order to acquire it they obtained options to buy the stock of the corporation that owned it. The total cost of acquiring the stock would be \$889,615. Of this, about \$500,000 had to be paid in cash, and they didn't have the money. But the corporation had quick assets that could be turned into cash, and the Davises made advance arrangements to do so.

Their plan worked well. In a series of transactions accomplished within a few days of September 22, 1953 the Davises exercised their stock options, had the corporation sell revolving fund certificates for cash, dissolved the corporation and took distribution of its assets, sold the lemon crop on the trees for cash, and used the cash thus raised to pay for the corporate stock. They had previously contracted to sell the lemon crop as soon as they should acquire it; the cash price for the crop was in escrow on September 17, 1953, and was transferred into the stock purchase escrow on or about September 22, 1953.

The Davises considered that they had bought the fixed assets of the orchard for the total cost of the stock less the cash raised by the pre-closing arrangements and used at the closing. [2R. pp. 311-312, 344-345.] And that was the economic reality. The Davises

did not have the money to buy the Del Norte stock and thereby acquire the orchard. What they could and did do was arrange in advance for conversion of corporate quick assets to cash and funnel that cash through to the corporate stockholders at point of purchase. This left the Davises with a price of \$448,837 to pay for the orchard. Since \$394,836 of that price was deferred, being represented by notes to stockholders and others, they were able to manage the purchase.

In the view of the taxpayers and the Tax Court [R. pp. 43, 47] this was a so-called *Kimbell-Diamond* acquisition, treated in the tax law as a purchase of corporate assets in substance even though accomplished in form by purchase of stock and dissolution of the corporation. In the theory of this line of tax cases, the buyer's acquisition and ownership of the corporation is disregarded as a transitory step. *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd.* 187 F. 2d 718 (C.A.5) *cert. den.* 342 U.S. 827; *United States v. Frank Mattison*, 273 F. 2d 13 (C.A. 9, 1959), 59-2 U.S.T.C. 9768; *United States v. M.O.J. Corporation*, 274 F. 2d 713 (C.A. 5, 1960), 60-1 U.S.T.C. 9209.

In some instances, the buyer is able to acquire the wanted fixed assets of a corporation and let its shareholders take distribution of the unwanted quick assets. *Cf. Prairie Oil & Gas Co. v. Motter*, 66 F. 2d 309 (C.A. 10, 1933), 12 A.F.T.R. 996; *Kanawha Gas & Utilities Co.*, 214 F. 2d 685 (C.A. 5, 1954), 45 A.F.T.R. 1805; *George Haiss Manufacturing Co.*, 16 T.C.M. 1106 (1957). But if, as in the present case, it is inconvenient or impossible to break apart the corporate assets as part of the contract with the selling shareholders, the buyer must proceed as the Davises did here.

that is, arrange for conversion of the unwanted quick assets to cash at point of purchase and channel the cash to the selling stockholders. In such circumstances the buyer's handling of the cash-out problem, like his dissolution of the acquired corporation, is but a transitory step in his acquisition of the wanted fixed assets.

On the other side of the coin, the Revenue Service, with the support of the courts, is firm in refusing loss deduction to a buyer who immediately cashes out one of the purchased assets of a bundle; in such circumstances, the cash-out results not in loss but in an adjustment of basis. *Tube Bar, Inc.*, 15 T.C. 922 (1950). Cf. *N.W. Ayer & Son, Inc.*, 17 T.C. 631 (1951) acq. 1952-1 C.B. 1; *The Hillside National Bank*, 35 T.C. 879 (1961).

II.

It Was Unrealistic for the Tax Court to Conclude From Opinion Testimony That the Value of Fixed Assets Exceeded Price Paid Therefor and Use This as a Basis for Ascertaining Profit in a Simultaneous Sale of Quick Assets.

Although a growing crop may not be inventory in the strict sense, it is the produce of the land or orchard and, like inventory, is normally converted to cash within a year or sooner. The Supreme Court has held that a growing citrus fruit crop is property held for sale to customers in the ordinary course of the business both of the grove owner who sells the orchard and of the grove owner who buys it. *Watson v. Commissioner*, 345 U.S. 544, 43 A.F.T.R. 621 (1953). This is by contrast to the orchard land and trees which, after six months holding, become equivalent to a capital asset for gain purposes.

I.R.C. Sec. 1231. At the point of its sale for cash a growing crop certainly may be termed a "quick asset" and a cash equivalent.

The fixed assets of the Del Norte Orchard were acquired by the Davises to hold and operate, and they have been held and operated. Gain on their sale has never been demonstrated; whereas inflationary trends since 1953 may indicate gain, it was only speculative on September 22, 1953. On the other hand, the quick asset, the lemon crop, was not acquired to hold; was readily convertible and immediately converted to cash, and was merely an element in a plan to funnel available cash to the sellers of the asset bundle. It is obvious that at September 22, 1953 the lemon crop was worth what it brought in immediate sale. But it is far from obvious that the fixed assets were then worth any more than the \$448,837 that was then paid for them. Only by assuming that the fixed assets were then worth more can any profit be found in the transactions of September 22, 1953 or attributed to the lemon crop.

The Tax Court was quite unrealistic in relying upon opinion testimony of an appraiser viewing the fixed assets in 1964, ten and a half years after they were bought, for its conclusion that on September 22, 1953 they were worth \$823,300, which was \$374,463 more than the price paid for them in the arms-length purchase transaction of that date; and even more unrealistic in transferring part of that theoretical profit to the point-of-purchase sale of the lemon crop, a quick asset.

Furthermore, the Tax Court patently misinterpreted the opinion testimony upon which it relied. It based its \$823,300 valuation of fixed assets on its conclusion that the two appraisers were largely in agreement as to

values [R. p. 55]; whereas even a cursory reading of Taschner's report [Ex. 28] reveals that his individual valuation figures for elements, such as land, trees, buildings and improvements, were relative and not indicative of the total value of the fixed asset group. Taschner's opinion was that fair market value of the fixed orchard assets as a whole was best demonstrated by the price paid for those assets, as derived from the price paid for the corporate stock less the corporate cash and cash to which corporate assets were promptly converted. [Ex. 28, p. 12.]

The Tax Court's substitution of a theoretical figure of \$823,300 for actual cost, as the 1953 value of the fixed assets, is thus impeached by its obvious misinterpretation of one of the two appraisals upon which it relied. If further impeachment were needed, we believe it appears in the other appraisal, made by Hoffman, analyzed under heading 4 of our Statement. We will not repeat that analysis here beyond noting that Hoffman's "comparables" were not parallel in size; and that in ignoring this purchase transaction he was rejecting the best evidence of the value of the property purchased.

We submit that the Tax Court committed manifest error in finding a theoretical value of \$823,300 for the fixed assets of the Del Norte orchard on September 22, 1953 when they were bought for \$448,837; and in attributing part of the theoretical profit of \$347,463 to the lemon crop acquired September 22, 1953 and sold that day for \$212,700. We believe this was an error of law. However any fact finding involved was clearly erroneous.

III.

In a Purchase of Current and Fixed Assets for a Lump-Sum, First Allocation of Price Generally Is Made to Quick Assets; Invariably so if They Are Promptly Converted to Cash.

A. The Commissioner Has Consistently Applied This Principle by Making First Allocation of Price to a Crop Purchased With the Land.

In 1920 the Commissioner issued O.D. 714, 3 C.B. 49, reading as follows:

“A purchased for a certain price land together with crops growing thereon. The basis for determining gain or loss upon a subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing.”

In not requiring a pro rata allocation between value of land and crop, but accepting crop value as its basis, this ruling is calling for first allocation of price to the crop. It has never been revoked or altered.⁸ Though it was cited to the Tax Court, the Court ignored it.

This ruling applies specifically to this case and requires that the \$212,700, found as fair market value

⁸It was cited with approval in I.T. 3815, 1946-2 C.B. 30. There are no regulations on the subject of first allocation of lump-sum price to a crop or other quick asset. Neither Reg. 1.61-6(a) nor Reg. 1.167(a)-5 refers to an allocation where current assets are included. Regs. 1.334-1(c)(4)(v)(b)(1) and (c)(4)(viii) call for first allocation to “cash and its equivalent” in the situation where one corporation buys at least 80% of the stock of another and dissolves it within two years.

of the lemon crop at acquisition, shall be treated as basis in determining gain on its sale. The effect, of course, is to eliminate gain, except for the \$25,000 (of the \$237,700) which was concededly paid for the Davises' obligation to care for the orchard while the crop was maturing.

As noted under heading 2 of our Statement, the Commissioner did not assert his deficiency on the ground that the lemon crop should receive percentage allocation like a fixed asset; he gave it first allocation along with the other quick assets. By singling out the crop for fixed asset allocation the Tax Court has anomalously distinguished one quick asset worth \$212,700 in cash at point of purchase from others worth \$228,078 in cash at point of purchase. The latter have continued to receive first allocation of cost even though some of them (receivables and lemons in the warehouse) obviously were converted into cash after the purchase date when the lemon crop was sold for cash.

Repudiation of O.D. 714 would cause consternation in farm circles. It has certainly not been the practice of a farmer who buys land or an orchard with a growing crop to have both the crop and the land appraised for the purpose of determining how much cost to allocate to the crop.⁹

⁹*Cf.* testimony of Herron, taxpayers' C.P.A. [2R. 572.]

B. The Commissioner and Courts Have Generally Agreed With the Normal Accounting Practice of Allocating the First Portion of a Lump-Sum Price to Current Assets Bought With Fixed Assets. Such First Allocation Is Always Made Where the Asset Is Immediately Converted and Equivalent to Cash.

Where fixed and current assets are bought in a bundle, as where a going business is purchased, it is normal accounting practice to allocate the first portion of cost to current assets, and then pro rate the remainder among fixed assets according to relative values. In the usual case any other method would work distortion. If a business is bought to operate it would be strange indeed to tax the buyer on an artificial profit in the purchased inventory and receivables arrived at by appraising the plant and real estate at a figure higher than the remainder of cost available for them, and reallocating total cost on a percentage basis among the inventory and receivables at cashable value and the plant and real estate at such appraised value. The point is that the inventory and receivables will be promptly cashed out in normal business operations. The plant and real estate will not be sold, but will be used to create and sell more inventory and will have a value to the buyer chiefly determined by whether and to what degree such operations prove to be profitable.

This principle has generally been recognized by the Commissioner and the Courts. In the great majority of cases first allocation of lump-sum price to quick assets of a purchased business or farm has not been disturbed.

The American Fork and Hoe Company, 2 T.C.M. 842 (1943); Philadelphia Steel & Iron Corporation,

23 T.C.M. 558 (1964), aff'd. 344 F.2d 964, 65-1 U.S.T.C. 9308; *Estate of James F. Suter*, 29 T.C. 244 (1957), acq. 1958-2 C.B. 8; *Richard J. Zemmer*, 22 T.C.M. 638 (1963); *Fox & Hounds, Inc.*, 21 T.C.M. 1216 (1962); *James K. Herbert*, 62-1 U.S.T.C. 9177 (Dist. Ct. Cal. 11/14/61); *Henry S. Alper*, 21 T.C.M. 185 (1962) (issue concerning Middlebelt Livonia); *Farmers Cotton Oil Company*, 27 B.T.A. 105 (1932), non-acq. on another point XII-1 C.B. 16.

In the *Herbert* case \$45,000 of the \$158,800 paid as price for the ranch represented a first allocation to the growing crop agreed to by both parties. The argument concerned the allocation of the remaining \$113,-800 among fixed assets.

In *Apex Brewing Co., Inc.*, 40 B.T.A. 1110 (1939), acq. 1940-1 C.B. 1, the Commissioner had allocated a lump-sum price pro rata among the fixed brewery assets and beer inventory. Taxpayer objected that this created a false profit upon disposition of the beer inventory. The full Tax Court agreed, holding that there must be allocation of the first portion of the lump-sum price to the inventory, with the balance spread among the fixed assets.

In *Harlan E. McGregor*, 14 T.C.M. 897 (1955), a taxpayer sold stored crops shortly after he had bought a farm and the crops for a lump-sum price. As a result of his allocation of price among all of the purchased assets, he claimed a crop basis in excess of sale price and a loss on the sale. The Commissioner fixed the basis of the crops at their sale price, which amounted to giving them first allocation of cost, and thereby eliminated the loss. The Court upheld the Commissioner.

In the only case of this kind where the Commissioner seems to have questioned the principle of first allocation to current assets, the Tax Court somewhat modified the principle by making first allocation to such items as cash, receivables, prepaid insurance, factory supplies and deferred charges, but considered that inventory and work in process required further effort and expense before they could be turned into cash and therefore were not the equivalent of cash; the Commissioner's allocation of cost to them was sustained for lack of better evidence. *F & D Rentals, Inc.*, 44 T.C. No. 32, C.C.H. Dec. 27,424 (1965). The case is pending on the taxpayer's appeal to the Court of Appeals Seventh Circuit.

There is a group of cases which may at first blush appear to cast doubt upon the principle of first allocation of a lump-sum price to current assets; but if they are properly analyzed they are not in point. These cases involve the purchase of a bundle of homogeneous assets and the liquidation of some of the assets from the bundle.

For instance, in *Nathan Blum*, 5 T.C. 702 (1945), one partner bought another's interest in partnership assets that consisted almost entirely of current assets. The Court stated and applied the principle that cost should be allocated to each asset of a purchased bundle upon the basis of its value as a percentage of the total value of the bundle. The taxpayer was attempting to defer any gain until he had recovered the total cost of this homogeneous bundle, which the Court refused to permit.

Likewise in *T. H. Symington & Son, Inc.*, 35 B.T.A. 711 (1937) the question concerned redemption of pre-

ferred stock out of a bundle of assets consisting of various securities and receivables that had been segregated into one corporation ostensibly for liquidation purposes. This was part of a complicated reorganization in which the fixed and operating assets went to another corporate entity. The preferred stock in question was homogeneous with the other assets in the bundle; as in *Blum*, the taxpayer was contending for recovery of the entire cost before reporting the profit on any disposition; specifically, was attempting to avoid tax on the premium paid when the stock was redeemed (originally reported as taxable in its return). In holding for the Commissioner, the Court noted (Op. 738) that the redemption, although shortly following the purchase, was not known or anticipated at the purchase.

The decision below against first allocation of cost to the lemon crop was rested on the *Blum* and *Symington* cases. [R. 50-52] This, we submit, was an error of law.

In *L. M. Graves*, 11 T.C.M. 467 (1952) the taxpayer purchased all of the assets of a corporation for the purpose of liquidating them; apparently they were all liquidated in a little over a year. Since the assets were all held for prompt sale they were homogeneous and deserved pro rata allocation of cost.

The *Blum* and *Graves* cases recognize in any event that a cash equivalent is entitled to first allocation. Insurance received it in *Blum*. Insurance and a promptly liquidated account receivable received it in *Graves* where the Court commented (11 T.C.M. 472-3) that “* * * cost must first be applied in full to any cash or to any asset that is substantially the equivalent of cash * * *.”

Accord *The Bessemer Limestone and Cement Company*, 15 T.C.M. 1277, 1283 (1956). We do not believe that reasonable contention could be made for pro rata allocation to fixed and current assets alike in the purchase of a going farm, manufacturing or mercantile business; but even if it were, it is obvious that a current asset immediately converted to cash is a cash equivalent and entitled to first allocation of cost.¹⁰

The clear rule of law ignored by the Tax Court was that the lemon crop in the instant case, a quick asset immediately converted to cash, was a cash equivalent, and was entitled to first allocation of cost. No gain was realized by cashing it out.

Conclusion.

The decision below should be reversed with instructions: to find no gain on the sale of the lemon crop for its acquisition value of \$212,700; to find that each of the Davis brothers had taxable income of 50% of the \$25,000 paid for the orchard care covenant; and to add a like amount to the basis of the fixed assets acquired by each.

Respectfully submitted,

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March 1966

¹⁰An accountant could not in good conscience certify to the realization of gain through such a conversion. See testimony of C.P.A. Herron, 2 R. 571-2.

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

ARTHUR A. ARMSTRONG

